

ST 04-20

Tax Type: Sales Tax

Issue: Exemption From Tax (Charitable or Other Exempt Types)

**STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS**

**THE DEPARTMENT OF REVENUE
OF THE STATE OF ILLINOIS,**

No: 03 ST 0000

Sales Tax Exemption Number

v.

ABC SERVICES,

TAXPAYER

**Kenneth J. Galvin
Administrative Law Judge**

RECOMMENDATION FOR DISPOSITION

APPEARANCES: Ms. Carolyn D. Duronio, Reed Smith LLP, on behalf of ABC Services; Mr. Shepard Smith, Special Assistant Attorney General, on behalf of the Department of Revenue of the State of Illinois.

SYNOPSIS: On November 5, 2003, the Illinois Department of Revenue (hereinafter the “Department”) denied the second request of ABC Services (hereinafter “ABC” or “applicant”) that the Department issue it an exemption identification number so that it could purchase tangible personal property free from the imposition of use tax as set forth in 35 ILCS 105/1 *et seq.* On November 25, 2003, ABC protested the Department’s decision and requested a hearing, which was held on August 19, 2004, with Jane Doe, Vice-President, Dr. John Doe, Medical Director for XYZ Blood Services, and Joe Blow,

Director of Accounting, testifying. The sole issue to be determined at the hearing was whether ABC qualified for an exemption identification number as “a corporation, society, association, foundation or institution organized and operated exclusively for charitable ... purposes.” 35 ILCS 105/3-5(4). Following a careful review of the evidence and testimony presented at the hearing, I recommend that the Department’s denial be affirmed.

FINDINGS OF FACT:

1. The Department’s case, inclusive of all jurisdictional elements, is established by the admission into evidence of the Department’s second denial of exemption dated November 5, 2003. Tr. p. 7; Dept. Ex. No. 1.
2. ABC administers three blood related operations: 1) “transfusion service” which finds compatible blood for transfusion through testing and product manipulation; 2) “red cell reference lab” which provides additional and complex testing for a small group of patients that cannot be handled at “transfusion service” because of serological problems; and 3) “cord blood and stem cell” service which recruits cord blood donors and cryopreserves cord blood (blood harvested from the umbilical cord following delivery) and stores it until it is needed for transplant. Tr. pp. 22-23, 34-35.
3. ABC participates in the “rare donor registry,” a voluntary association of blood centers throughout the country creating a central depository of information on rare blood donors. “Rare” applies to less than 1% of the population. ABC contacts donors and imports units to take care of local patients and tests local patients for rare blood. In 2003, ABC typed over 50,000 local patients to find 225 units of rare blood. Tr. pp. 27-29, 32-33.

4. ABC's Form 990, "Return of Organization Exempt From Income Tax," for year 2002 shows total revenue of \$14,913,428, total expenses of \$12,670,967 and an excess of revenue over expenses of \$2,242,461. Of the total revenue, \$14,829,860 (over 99%) is composed of "fees for providing blood related services," \$18,510 (less than 1%) is composed of "government contributions (grants)." Tr. pp. 8, 63; Dept. Ex. No. 2.
5. ABC's Articles of Incorporation, filed under the Pennsylvania Nonprofit Corporation Law of 1988, state, *inter alia*, that ABC's purpose is to "establish, develop, sponsor, promote and/or conduct educational programs, laboratory research, and therapeutic services, treatment facilities, human services programs and other charitable activities devoted to improving and protecting the health and welfare of all persons, including providing opportunities to aid persons suffering from physical disabilities, providing access to community resources aimed at promoting life and health, and providing assistance to persons with the aim of leading full and meaningful lives." Tr. p. 10; Applicant's Ex. No. 1.
6. ABC's Bylaws state that the Corporation shall have "one member with full voting rights, which shall be The Institute for Transfusion Medicine ...". If ABC were dissolved, its assets would be transferred to the Institute for Transfusion Medicine if it remains a not-for-profit entity. Tr. pp. 11, 15, 56-57; Applicant's Ex. Nos. 2 and 7.
7. ABC is exempt from federal income taxes "under Section 501(a) of the Internal Revenue Code as an organization described in Section 501(c)(3)." Tr. pp. 11-12, 55; Taxpayer's Ex. No. 3.

CONCLUSIONS OF LAW:

An examination of the record establishes that ABC has not demonstrated, by the presentation of testimony or through exhibits or argument, evidence sufficient to warrant an exemption from sales tax. Accordingly, under the reasoning given below, the determination by the Department denying the applicant a sales tax exemption number should be affirmed. In support thereof, I make the following conclusions:

It is well established that there is a presumption against exemption and that therefore, “exemptions are to be strictly construed” with any doubts concerning the applicability of the exemption “resolved in favor of taxation.” Van’s Material Co. Inc. v. Department of Revenue, 131 Ill. 2d 196 (1989). The applicant bears the burden of proving “by clear and convincing” evidence that the exemption applies. Evangelical Hospitals Corp. v. Department of Revenue, 223 Ill. App. 3d 225 (2d Dist.1991).

ABC seeks to qualify for an exemption identification number as a “corporation, society, association, foundation or institution organized and operated exclusively for charitable...purposes[.]” 35 ILCS 105/3-5(4); 35 ILCS 120/2-5(11). In Methodist Old People’s Home v. Korzen, 39 Ill. 2d 149 (1968), the Illinois Supreme Court outlined a number of factors to be considered in assessing whether an organization is actually an institution of public charity: (1) the benefits derived are for an indefinite number of persons [for their general welfare or in some way reducing the burdens on government]; (2) the organization has no capital, capital stock or shareholders; (3) funds are derived mainly from private and public charity, and the funds are held in trust for the objects and purposes expressed in the charter; (4) the charity is dispensed to all who need and apply for it, and does not provide gain or profit in a private sense to any person connected with

it; (5) the organization does not appear to place obstacles of any character in the way of those who need and would avail themselves of the charitable benefits it dispenses.

Applying the guidelines from Methodist Old People's Home, I conclude that ABC has not presented clear and convincing evidence that it is, in fact, a charitable organization. ABC's Form 990, "Return of Organization Exempt From Income Tax," for year 2002 shows total revenue of \$14,913,428, total expenses of \$12,670,967 and an excess of revenue over expenses of \$2,242,461. More than 99% of the total revenue is composed of "fees for providing blood related services." Less than 1% of the total revenue is from "government contributions (grants)." Tr. pp. 8, 63; Dept. Ex. No. 2. Part IV-A of ABC's Form 990 shows that from 1999 through 2001, ABC had revenue averaging approximately \$13.3 million per year for a total for the three years of approximately \$40 million. Total contributions for the three-year period, 1999 through 2001, were \$433,526, approximately 1% of total revenue. The Methodist Old People's Home guideline that a charity's funds be derived mainly from public and private charity has not been met by ABC for the past three years and is not currently being met by the applicant.

Moreover, I am unable to conclude from ABC's Form 990 for 2002 and the evidence admitted at the hearing that the applicant is organized "exclusively" for charitable purposes or that its primary purpose is charitable. An "exclusively" charitable purpose need not be interpreted literally as the entity's sole purpose; it should be interpreted to mean the primary purpose, and not a merely incidental or secondary purpose. Gas Research Institute v. Department of Revenue, 154 Ill. App. 3d 430 (1st Dist. 1987). ABC estimated that the value of its charitable contributions in 2003 was

\$1,169,579. Dept. Ex. No. 3. Assuming, *arguendo*, that this amount is in fact a charitable contribution, it represents less than 8% of ABC's total revenue for 2002. Looking only at the financial information supplied by ABC, its charitable contributions are certainly "incidental" in comparison to the fees it earns for providing blood related services.

I conclude from the Applicant's Form 990 and the testimony at the evidentiary hearing that ABC's primary purpose is not exclusively charitable. ABC's primary purpose is to generate revenue by "providing blood related services." By providing these services, ABC has an excess of revenue over expenses in year 2002 of \$2,242,461, or approximately 15% of its total revenue. In Sisters of St. Francis v. Board of Review, 231 Ill. 317, 321 (1907), the court stated that a charitable organization does not lose its exemption by reason of the fact that those patients received by it who are able to pay are required to do so, as long as all the money received by it is devoted to the general purposes of the charity, and no portion of the money received by it is permitted to inure to the benefit of any private individual engaged in managing the charity. No evidence was presented at the hearing that ABC's \$2,242,461 excess of revenue over expenses in 2002 was devoted or earmarked for charitable purposes and I am unable to conclude that these funds are held in trust for charitable purposes.

Another guideline from Methodist Old People's Home is that a charity not provide gain or profit in a private sense to any person connected with it. The financial information provided by ABC does not indicate that the fees it earns from providing blood related services do not inure to the benefit of individuals engaged in managing the organization. ABC's Form 990 shows that Jane Doe, "Vice President/Secretary" of ABC earned compensation of \$180,879 in 2002 plus "contributions to employee benefit plans"

of \$14,201. Three other officers, ABC's President, Vice-President, and Treasurer, with each officer spending 1-2 hours/week "devoted to [their] position" earned zero in compensation from ABC. However, each of the three officers was compensated by The Institute for (the "Institute") and was listed on ABC's Form 990 for 2002 as earning "compensation from related organizations."

ABC is controlled by the Institute and ABC's bylaws state that the applicant shall have one member with full voting rights, which shall be the Institute. Tr. pp. 11, 15, 57; Applicant's Ex. No. 2 and 7. In 2002, the Institute paid the President of ABC \$532,233 plus "contributions to employee benefit plans" of \$52,298. The Institute paid the Vice-President of ABC \$165,871 plus \$17,176 in benefits and the Treasurer of ABC was paid \$327,360 plus \$35,924 in benefits. The executive director of ABC was paid \$84,192 by ABC plus \$9,211 in benefits. Thirty-three employees of ABC were paid over \$50,000/year in 2002. Dept. Ex. No. 2.

Such substantial salaries are not, *per se*, unreasonable, but they are more indicative of salaries paid by a profit-making business than of salaries paid by an "exclusively" charitable organization. ABC argues that the salaries are "reasonable" because the Internal Revenue Service imposes an excise tax on 501(c)(3) organizations if they pay more than "reasonable" salaries. "This compensation ... has been submitted to the IRS, and the IRS has not imposed an excise tax." "... [T]he excise tax has not been imposed, and therefore, it's reasonable compensation." Tr. pp. 101-102. ABC's argument is insufficient for me to find that these salaries are "reasonable." The Form 990 containing the above salary information was signed on February 9, 2004. No documentary evidence was offered by ABC to show that the Internal Revenue Service

had not imposed an excise tax on the salaries and the Internal Revenue Service would apparently not be time-barred from imposing an excise tax now. If no excise tax is imposed, it still does not indicate that the salaries are reasonable. Exemption from federal taxes is not determinative of whether an organization is charitable under the Illinois Constitution. The People ex rel. County Collector v. Hopedale Medical Foundation, 46 Ill. 2d 450 (1970). No financial statements for the Institute were offered into evidence and without financial and other information on the Institute, I am unable to conclude that the organization qualifies as a charity under Illinois law.

It is recognized that the employees of a charitable institution are not compelled to perform free services in order that the institution may be charitable. Yates v. Board of Review, 312 Ill. 367 (1924). “The payment of reasonable salaries to necessary employees for services actually rendered does not convert a nonprofit enterprise into a business enterprise.” 86 Ill. Admin. Code §130.2005(h). However, ABC’s salaries are significant enough to raise questions as to whether its employees and officers are the primary beneficiaries of ABC’s existence. ABC receives over 99% of its revenue from selling blood related services and less than 1% from contributions. It is suggested that private contributors would cease to be contributors if they perceived that their donations were being used to pay such high salaries. No documentary evidence was presented as to how ABC’s salaries compared to similar organizations. There was testimony at the evidentiary hearing that no employee of ABC receives compensation that is a “function of the revenue or assets” of ABC. Tr. p. 56. This testimony alone is wholly inadequate for me to conclude that the salaries paid to ABC’s officers and employees were reasonable or that the revenue received by ABC does not inure to the benefit of these

private individuals. Based on the evidence presented, I am unable to conclude that ABC is not providing gain or profit in a private sense to officers and employees connected with the organization.

As stated previously, ABC estimated the value of its charitable contributions in 2003 as \$1,169,579. Testimony about ABC's contributions was unclear and misleading. For example, Dr. John Doe testified that he spends about two hours per week consulting on transfusion issues with technical staff at hospitals and with patient's physicians. "We don't have a charge for that." Tr. pp. 45-46. He also testified that he spends approximately six hours teaching about transfusion services to pathology residents and post-graduate medical staff. Tr. pp. 48-49. ABC does not charge for this. Tr. p. 50. "No participant at any of the educational services pays a fee, and no patient having difficult blood related issues pays a fee for consulting with Dr. John Doe." The cost of these educational programs was estimated to be \$459,114, which is 39% of the \$1,169,579 in total contributions estimated by ABC for 2003. The \$459,114, which ABC refers to as "uncompensated services" was calculated "by multiplying the compensation paid to the employees providing the educational and consultative services by the percentage of their time spent providing the educational and consultative service." Dept. Ex. No. 3.

The problem with this testimony is that Dr. John Doe is not employed by ABC. On direct examination, Dr. John Doe was asked his position. He responded: "I am the medical director for the XYZ Blood Services." Tr. p. 44. On cross-examination, Dr. John Doe was asked who he was employed by and he stated that that he was "employed by XYZ Blood Services." Tr. p. 53.

Q. So any free services that are going to be provided for you
will come out of XYZ since they are paying your

- salary, it's going to come from XYZ; is that correct?
- A. I would suspect, yes, because my salary does come from Life Sources and not [ABC].

Tr. p. 53. No questions were asked of Dr. John Doe on redirect. Tr. p. 54.

It was never explained how free consultation and free education programs for medical personnel who are presumably going to recommend ABC's services to fee paying customers can be considered a charitable contribution. Assuming the consultation and education are charitable, it was never explained how the "uncompensated services" of Dr. John Doe can be considered a contribution of ABC when Dr. John Doe is not an employee of ABC.

According to ABC's Form 990, "XYZ" is a "related organization." Dept. Ex. No. 2. There was testimony at the evidentiary hearing that ABC "controls" XYZ. Tr. p. 57. Although this may be the case, XYZ is not the applicant and is not applying for the sales tax exemption. No financial statements or other information was admitted for XYZ and I am unable to conclude that XYZ is a charitable organization in accordance with Illinois statutes. The situation with XYZ is the opposite of the situation with the salaries paid to ABC's officers by the Institute, discussed above. ABC apparently wants to consider XYZ' charitable contribution of \$439,114 as the charitable contribution of ABC. On the other hand, ABC apparently wants to consider the salaries paid to its officers by the Institute, which is also a "related organization," as not paid by ABC. In effect, ABC wants this tribunal to consider the financial information of its related organizations, but only if the information is favorable toward ABC's request for a sales tax exemption.

In exemption cases the applicant, which in this case is ABC and not its "related organizations," bears the burden of proving by "clear and convincing" evidence that the

exemption applies. Evangelical Hospitals Corp. v. Department of Revenue, 223 Ill. App. 3d 225 (2d Dist. 1991). Any and all doubts that arise in an exemption proceeding, if attributable to evidentiary deficiencies, must be resolved in favor of taxation. Gas Research Institute v. Department of Revenue, 154 Ill. App. 3d 430 (1st Dist. 1987). ABC's estimate of charitable contributions of \$1,169,579 for 2003 includes other amounts, beside Dr. John Doe's, for "uncompensated services." Dr. John Doe's testimony, the lack of clarification on the issues involved and ABC's selective inclusion of financial information on its related organizations raise considerable doubt about the other amounts included in "uncompensated services" for 2003.

There was testimony at the evidentiary hearing that ABC has no written policies to waive fees or write off uncollectible accounts. Tr. pp. 42-43; Dept. Ex. No. 3. The lack of written policies can be considered an "obstacle" in the way of those who would avail themselves of ABC's benefits. It is unclear how anyone needing their services but unable to pay for them would know that free services are available. There was no testimony at the evidentiary hearing, other than anecdotal testimony, as to specifically how many people were helped by ABC at no charge. ABC does not have capital stock or shareholders. Tr. p. 55. As far as I can determine, this is the only Methodist Old People's Home guideline that is truly met by ABC. Meeting one guideline does not provide a sufficient basis for me to conclude that ABC is in fact a charitable organization.

It is my recommendation that the Department's denial of ABC's request for a sales tax exemption be affirmed.

November 19, 2004

Kenneth J. Galvin
Administrative Law Judge